



DEFENSE FINANCE AND ACCOUNTING SERVICE
ARLINGTON

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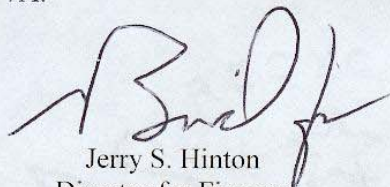
DFAS-DFM

MEMORANDUM FOR DIRECTOR, MILITARY PAY OPERATIONS, DEFENSE
FINANCE AND ACCOUNTING SERVICE (PM/CL)

SUBJECT: Interim Change to the DoDFMR, Vol 7A, Chapters 35, 44 and 45, Regarding
Various Tax Issues (DFAS Item L-37)

Attached is Interim Change 50-02 to Chapters 35, 44 and 45 of the Defense Financial Management Regulation (DoDFMR), Volume 7A. This change is effective immediately unless otherwise specified. It revises the severance pay tax refund policy, clarifies certain items of taxable pay in Chapters 44 and 45 and revises Tables 44-1 and 45-1.

We have evaluated your comments on the proposed change and included your comments where appropriate. Assignment of the interim change number is your authority to initiate procedural modifications to implement this change. Use the attached to initiate the formal change to the DoDFMR, Volume 7A.


Jerry S. Hinton
Director for Finance

Attachment:
As stated

cc: OUSD(C)(ODCFO)(FP)
DASD(MPP)(Comp)
ODGC(F)
Service Liaisons
USCG/NOAA/PHS Liaisons
DFAS-GAM/DE
DFAS-PMJE/DE
DFAS-DDM/CL

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Chapter 35
Disability Severance Pay
Taxability and Withholding

1. Revise paragraph 350205 to read:

“350205. Recoupment of Separation Pay from Retired or Retainer Pay or from Department of Veterans Affairs (DVA) Disability Compensation. Except as provided under subparagraph 350205.C, below, military members who receive separation pay, severance pay, or readjustment pay under any provisions of law based on service in the Armed Forces and, subsequently, either qualify for retired or retainer pay under 10 U.S.C. (reference (c)) or 14 U.S.C. (reference (bu)) or become eligible for disability compensation administered by the DVA, are subject to the recoupment of the separation, severance, or readjustment pay they receive which shall be accomplished from retired or retainer pay or DVA disability compensation, as follows:

A. Retired Pay. Recoupment shall be accomplished through monthly deductions from each payment of retired or retainer pay payable to the retired member until the total amount of the deductions equals the gross taxable amount of separation, severance, or readjustment pay received by the member. NOTE: See Chapter 4 of Volume 7B of this Regulation (reference (cn)) for guidance on the calculation of the recoupment.

B. DVA Disability Compensation. Recoupment shall be accomplished through a deduction from the DVA disability compensation payable to the retired member in an amount that is equal to the gross taxable amount of separation, severance, or readjustment pay received by the member. With respect to payments of separation, severance, or readjustment pay made after September 30, 1996, the amount to be deducted from the DVA disability compensation shall be equal to the gross taxable amount of such separation, severance, or readjustment pay, less the amount of federal income tax withheld from such pay at the flat withholding rate for supplemental payments prescribed under Chapter 24 of the Internal Revenue Code. This reduction, however, shall not apply to disability compensation in which the entitlement to that disability compensation is based on a later period of active duty than the period of active duty for which the separation pay, severance, or readjustment was received.

C. Repay Severance or Readjustment Pay. Notwithstanding subparagraphs 350205. A and B, above, members who received severance or readjustment pay before September 15, 1981, and who, on or after September 15, 1981, became entitled to retired or retainer pay under 10 U.S.C. (reference (c)) or 14 U.S.C. (reference (bu)) are required to repay the severance or readjustment pay, in accordance with the laws in effect on September 14, 1981.”

2. Revise the first sentence under subparagraph 350404.B to read:

“Withhold income taxes from all payments of ...under subparagraph 350404.A, above. Finance or ...that their taxable payments of disability severance pay will become non-taxable, if, later in the same tax year or in a subsequent tax year, the DVA awards the member disability compensation for the same illness or injury for which the member was paid disability severance pay. See subparagraphs 350404.C and D for how to obtain a refund of the income taxes withheld from disability severance pay that becomes non-taxable as a result of the DVA’s award, at a later date, of DVA disability compensation.”

3. Revise subparagraphs 350404.C and D to read:

“C. DVA Disability Compensation Awarded in the Tax Year of the Disability Severance Pay Payment. Finance or... withheld from the gross taxable amount of their disability severance pay payment may... same tax year... pay. To obtain a... from the servicing DFAS site, the member’s tax refund request must be received and processed by December 31st of the year in which the disability severance payment was paid, along with documentation evidencing the DVA’s award of disability compensation in the same year for the same injury or illness that established the member’s entitlement to disability severance pay. A corrected Form W-2 reducing the member’s taxable wages by the gross amount of the disability severance payment amount may be issued when supporting documentary evidence of the same year DVA award is received after the cutoff date.”

D. DVA Disability Compensation Awarded in a Tax Year Subsequent to the Year of the Disability Severance Pay Payment. Finance... withheld from their disability severance pay payment ... (IRS) when the date of the DVA’s award of disability compensation is in a calendar year subsequent to the year in which the member received disability severance pay. No prior year corrected Form W-2 may be issued to the member, since the member’s disability severance pay was taxable at the time of payment. The member should also... to claim a reduction in that year’s taxable income.”

4. Revise subparagraph 350406 to read:

“350406. Recoupment from DVA Compensation. The DVA deducts disability severance compensation from any DVA compensation for the same disability to which the member or the member’s dependents become entitled under any law administered by the DVA.

Chapter 44
Withholding Income Tax

5. Revise subparagraph 440102.A. to read:

“A...

1. Prior to March 20, 1996. All of the compensation of members (officer or enlisted) for any month during any part of which such members performed active duty in a combat zone, which qualified them for the combat zone tax exclusion under subparagraph 440103.C, even though only \$500 of the compensation of a commissioned officer (O-1 and above) was excluded from taxation.

2. Effective March 21, 1996. All of the compensation of an enlisted member or warrant officer for any month during any part of which such members perform active duty in a combat zone or qualified hazardous duty area (QHDA) (defined in subparagraph 440103.B), qualifying them for combat zone tax exclusion (generally referred to as CZTE) under subparagraph 440103.C. For commissioned officers, no more than an amount equal to the maximum CZTE (defined below) in effect for any month during any part of which such officers perform active duty in a CZTE or QHDA, qualifying them for combat zone or qualified hazardous duty area tax exclusion under subparagraph 440103.C.

3. Maximum CZTE. The amount of the maximum CZTE in effect for a qualifying month equals the sum of the highest rate of enlisted basic pay payable under Table 2-8, Note 2 and the amount of hostile fire/imminent danger pay actually payable to the officer for the qualifying month. Also see Column D of rules 1 through 4 under Table 44-1 and Chapter 10.”

6. Revise subparagraph 440102.C. to read:

“C. Puerto Rico. For members who claim Puerto Rico as their state of legal residence, Federal income tax withholding is precluded when military pay is properly subject to Puerto Rico tax withholding (when the member performs permanent duty outside the United States). Puerto Rico tax withholding is not required for military pay earned but unpaid at the date of death of a military member. “

7. Revise 440106.B. to read:

“B. Legal Residence. Each member must designate a legal residence and report any changes of legal residence. A member’s legal residence does not change because of change of permanent station. Legal residence at the time of entry into the Armed Forces remains the same until changed by the member. Notification of legal residence or change of legal residence must be accomplished by the member using a DD Form 2058 (State of Legal Residence Certificate).”

8. Renumber subparagraph 440106.C as 440106.D and add a new subparagraph 440106.C to read:

“C. Native Americans. States are prohibited from taxing the military compensation of Native American service members who claim a federally recognized tribal reservation as their state of legal residence. Notification of a federally recognized tribal reservation as a state of legal residence must be accomplished by the Native American service member using DD Form 2058-2 (Native American State Income Tax Withholding Exemption Certificate).”

9. Renumber subparagraphs 440106.D and E as 440106.E and F.**10. Revise renumbered subparagraph 440106.D to read:**

“D. Withholding. Compensation for military service that is subject to federal taxation also is subject to the mandatory withholding of income taxes on behalf of those states (including the District of Columbia) that have entered into an agreement for the purpose of such withholding with the Secretary of Treasury. The following states have entered into such an agreement:

<u>State</u>	<u>Effective Date To Commence Withholding</u>
Alabama	July 1, 1977
Arizona	September 1, 1993
Arkansas	March 30, 1981
California	February 1, 1978
Colorado	August 1, 1977
Connecticut	January 1, 1992
Delaware	July 1, 1977
District of Columbia	August 1, 1977
Georgia	January 1, 1979
Hawaii	December 1, 1977
Idaho	July 1, 1977
Illinois	July 1, 1977
Indiana	August 1, 1977
Iowa	July 1, 1977
Kansas	July 1, 1977
Kentucky	September 1, 1977
Louisiana	September 1, 1977
Maine	November 1, 1977
Maryland	August 1, 1977
Massachusetts	August 1, 1977
Michigan	July 1, 1977
Minnesota	November 1, 1977
Mississippi	July 1, 1978
Missouri	January 1, 1993
Nebraska	September 1, 1977

New Jersey	July 1, 1977
New Mexico	July 1, 1977
New York	July 1, 1977
North Carolina	July 1, 1977
North Dakota	July 29, 1987
Ohio	September 1, 1978
Oklahoma	September 1, 1977
Oregon	November 1, 1977
Pennsylvania	July 1, 1977
Puerto Rico	February 15, 1998
Rhode Island	August 1, 1977
South Carolina	July 1, 1977
Utah	July 1, 1977
Vermont	January 1, 1990
Virginia	July 1, 1977
West Virginia	July 1, 1977
Wisconsin	August 1, 1977"

11. Replace Table 44-1 with Tab A.

12. Revise the text of section 4501 to read as follows:

"The Federal Insurance Contribution Act (reference (ci)) requires federal agencies to withhold FICA (Social Security and Medicare) taxes from the basic pay of military members covered by the Social Security Act and to pay matching FICA taxes to the SSA. See Table 45-1 for the FICA tax component for old age, survivors, and disability insurance (OASDI) tax, also called Social Security tax, and the FICA tax component for hospital insurance (HI) tax, also called Medicare tax. The OASDI tax rate applies only to those basic pay payments that do not exceed the annually variable OASDI wage base. There is no cap on wages subject to the withholding of Medicare tax."

13. Replace Table 45-1 with Tab B.

14. In the bibliography, change 350205B to read 350205B and C.

15. In the bibliography, under 350406, add the following citation:

"Public Law 104-201, Section 653, Sep 23, 1996"

16. In the bibliography, under 440102A, add the following citation:

"IRS Publication 3"

17. In the bibliography, insert the following:

“440106C

OASD/FMP Memo,
March 6, 2001

440106D

TFM, Part 3, Chapter 5000”

18. In the bibliography, under Table 44-1, Note 14, add the following citation:

“IRS Publication 15-B”

TAXABILITY OF ITEMS OF MILITARY PAY AND ALLOWANCES				
R U L E	A	B		
	If item is	then item is (notes 5, 9, and 10)		
		taxable and subject to federal/state income tax withholding	taxable but not subject to federal/state income tax withholding	not taxable
1	basic pay (note 1)	for any month combat zone or qualified hazardous duty area exclusions do not apply (notes 2 and 13).		all pay earned by an enlisted member or warrant officer (W-1 through W-5). Beginning November 21, 1995 for commissioned officers (O-1 and above) in amounts up to the highest rate of pay payable to any enlisted member plus the amount of hostile fire/imminent danger pay that is actually payable to the officer for any month combat zone or qualified hazardous duty area tax exclusion applies (notes 2 and 7); or, for any member while in a missing status and authorized tax exclusion under the provisions of subparagraph 440102.A. For periods on or before November 20, 1995 for commissioned officers (O-1 and above), up to \$500 per month of such pay for any month combat zone tax exclusion applies.
2	incentive pay for hazardous duty (see Chapters 22-24)			
3	special pay (see Chapters 5-21)			
4	lump-sum payment of accrued leave (basic pay portion)			
5	separation pay, readjustment pay, or severance pay (except for disability)(note 6)	remains taxable income subject to reporting and withholding if paid during any month the combat zone exclusion applies.		
6	contract cancellation pay			
7	selective or regular reenlistment bonus (including applicable installments)	if reenlistment or extension occurs in a month during which combat zone exclusion does not apply.		if reenlistment or extension occurs in a month during which combat zone or qualified hazardous duty area exclusion applies.
8	pay forfeited by court-martial sentence or non-judicial punishment			and is loss of entitlement to pay in the amount of the forfeiture (however, remaining pay is subject to tax withholding (note 3)).
9	payment(s) in excess of actual travel and transportation costs incurred while carrying on business of U.S. Government (includes any temporary lodging entitlements)		and will not be reported on TD Form W-2 or 1099. The member will account for such payment(s) on individual income tax return.	

Table 44-1. Taxability of Items of Military Pay and Allowances

TAXABILITY OF ITEMS OF MILITARY PAY AND ALLOWANCES				
R U L E	A	B		
	If item is	then item is (notes 5, 9, and 10)		
		taxable and subject to federal/state income tax withholding	taxable but not subject to federal/state income tax withholding	not taxable
10	incentive payment paid to member for do-it-yourself move per JFTR, part D, Chapter 5	at time of payment.		
11	muster duty allowance	at time of payment under the provisions of subparagraph 580106.C.		
12	funeral duty allowance	at time of payment.		
13	personal money allowance	and will be reported on Form W-2.		
14	an allowance (BAS, BAH, FSA, clothing and uniform allowances, and overseas station allowances) (note 8)			at any time.
15	death gratuity		to the extent the total payment for any death exceeds \$3,000 and reported on TD Form 1099-MISC (note 11).	
16	otherwise taxable item of pay earned by member but unpaid at death		but will be reported on TD Form 1099-MISC when paid to beneficiary (note 4).	if death occurs in month member was entitled to combat zone or qualified hazardous duty area exclusion.
17	special separation benefit or voluntary separation incentive	at the flat withholding rate (currently 27 percent) for FITW and at appropriate SITW rate for SSB payments and initial VSI payments. Withhold taxes from VSI installment payments at the annual withholding rate contained in IRS Circular E (note 12).		

Table 44-1. Taxability of Items of Military Pay and Allowances (Continued)

TAXABILITY OF ITEMS OF MILITARY PAY AND ALLOWANCES

R U L E	A	B		
	If item is	then item is (notes 5, 9, and 10)		
		taxable and subject to federal/state income tax withholding	taxable but not subject to federal/ state income tax withholding	not taxable
18	inactive duty for training (IDT) pay	at time of the payment (CZTE does not apply to pay for IDTs).		
19	former captive payment (see Chapter 37)		if payment is for former captive status resulting from a lawful action. Payment will be reported on IRS Form W-2 (note 4).	if payment is for former captive status resulting from the deprivation of personal rights.
20	employer provided home-to-work transportation	even if transportation is provided for security reasons (note 14).		
21	employer-provided parking	to the extent that the value exceeds the monthly exclusion limit (note 14).		to the extent that the value is equal to or less than the monthly exclusion limit.
22	Thrift Savings Plan	deferred until contributions are withdrawn.		if TSP contribution is made from pay earned in a combat zone or qualified hazardous duty area (for commissioned officers, limited to maximum monthly CZTE amount).
23	waived portion of court martial forfeiture of taxable pay or pay and allowances (Chapter 48)	see subparagraph 480306.C		

NOTES:

1. Excludes the reduction of basic pay for educational benefits under the "New Montgomery GI Bill" after December 31, 1985 (38 U.S.C. 1411).
2. Add the payments (rules 1 through 6) made currently or at a later date for a commissioned officer (O-1 and above) to other pay for the month (up to the highest rate of pay payable to any enlisted member) to calculate the maximum amount to be applied for combat zone or qualified hazardous duty area tax exclusion. (See subparagraph 350103.B.)
3. This does not apply to fines imposed by court-martial or non-judicial punishments. Withhold tax from the member's full pay credited before deducting the fine. Report the full amount of the pay credited, without deducting the fine, as taxable income.
4. Report any otherwise taxable item of pay earned by member but unpaid at death in Box 3 of TD Form 1099-MISC. Enter Federal income tax withheld or backup withholding in Box 4 of the TD Form 1099-MISC. Exception is pay earned for any month combat zone or qualified hazardous duty area exclusion applies. Combat zones and qualified hazardous duty areas are so designated by Executive Order or statute, respectively.
5. The susceptibility of items of military pay and allowances to state income taxes depends upon the law of the member's state of legal residence. Items of pay and allowances, which are not subject to Federal Income Tax Withholding (FITW), however, will not be subject to State Income Tax Withholding (SITW). Items of pay and allowances subject to FITW will be subject to SITW if the member's state of legal residence has entered into a withholding agreement with the Secretary of the Treasury. The total or partial exclusion by states of military pay from income will be recognized in the computation of the amount of state income tax to be withheld.

Table 44-1. Taxability of Items of Military Pay and Allowances (Continued)

6. See paragraph 350404 of this volume for exceptions to the normally taxable payment of disability severance pay.
7. Only pay and allowances actually earned during any month in which a combat zone or qualified hazardous duty area designation applies are excludable, even if paid in a later, non-qualifying month. Entitlements earned during any non-qualifying month, but paid in a month the exclusion applies, remain taxable. Accrued leave payments qualify only for that portion of days that were actually earned during a qualifying month.
8. Allowances considered nontaxable on September 9, 1986 remain nontaxable. Any allowance created after September 9, 1986 will be taxable for federal and state income tax purposes unless specified otherwise.
9. If a member receives an overpayment of a taxable pay item, then the overpayment should be reported in the year paid unless the combat zone or qualified hazardous duty area tax exclusion is applicable. If recovery of the overpayment is waived, remitted, or canceled, there are no additional tax reporting requirements. If the overpayment consists of a nontaxable pay item, then the overpayment should not be reported as taxable income if the resulting debt is waived, remitted, or canceled.
10. Taxable wages and withholding must reflect the debt in the year the payment was received. Collection action will reflect impact on taxable wages and withholding (if applicable) as collection is made, but only if made in the same year as the original payment.
11. The amount of death gratuity payment made to survivors of military members who died after August 20, 1996 that is excluded from income may not exceed \$3,000 regardless of the number of beneficiaries. If there are multiple beneficiaries, the \$3,000 exclusion must be proportionately applied. Report all death gratuity payments separately, using a TD Form 1099-MISC. Report the taxable amount of each payment in box 3. For members who died on or before August 20, 1996, the maximum exclusion amount is \$5,000.
12. SSB and VSI payments remain taxable even if a member signs the agreement to separate while serving in a combat zone or qualified hazardous duty area.
13. Effective April 1, 1996 for combat zone and qualified hazardous duty area tax exclusion for commissioned officers (O-1 and above), amounts over the highest enlisted grade (Sergeant Major of the Army, Master Chief Petty Officer of the Navy, Chief Master Sergeant of the Air Force, or Sergeant Major of the Marine Corps; (see Table 2-8, note 2, for clarification) plus the amount of hostile fire/imminent danger pay that is actually payable to the officer for that month are taxable and subject to federal and state tax withholding.
14. Home-to-work provided transportation and employer provided parking.
 - a. Per DoD 4500.36-R, the USD(C) and USD (P&R) jointly will issue updated annual guidance concerning the valuation, on a monthly basis, of taxable government employer-provided home-to-work transportation fringe benefits provided to certain military members. Armed Forces Tax Council service representatives annually will distribute the updated guidance to the Military Services.
 - b. Each DoD Component will determine the value, to be calculated on a monthly basis, of government employer-provided taxable parking fringe benefits provided to military members.
 - c. Determination must be accomplished utilizing the provisions of the Internal Revenue Code (See IRS Publication 15-B) and Treasury Regulations and accordingly documented.
Each member's Service shall:
 - (1) Identify members receiving government employer-provided home-to-work transportation and/or parking fringe benefits;
 - (2) Certify fringe benefit was authorized, calculate and certify the value of the taxable fringe benefits, and submit the appropriate taxable gross income amounts to the servicing DFAS central site, no less often than once a year. Exception: When members receive taxable fringe benefits from active duty assignments outside their DoD Component, the agency providing the taxable fringe benefit (such as parking) calculates the value of the benefit provided, and the member's Service verifies the correctness of the calculation;
 - (3) Keep members receiving such benefits advised of the tax liability annually accruing to them.
 - d. Each member's certified taxable fringe benefit amount must be sent to the servicing DFAS central site no less often than annually and not later than December 15, each year, for processing to:
 - (1) Include the taxable non-cash benefit amounts in members' gross income;
 - (2) Withhold and deduct appropriate federal and state income taxes (not FICA taxes);
 - (3) Generate a TD Form W-2 that reflects the adjusted gross income and withholding amounts. The military services' field finance offices are not authorized to process taxable fringe benefits as additional taxable wages, to withhold applicable taxes, or to generate a manual TD Form W-2.

Table 44-1. Taxability of Items of Military Pay and Allowances (Continued)

FICA PERCENTAGES AND MAXIMUM TAXABLE WAGES AND MAXIMUM TAX

Year	Social Security (OASDI) Tax	+	Medicare Hospital Insurance (HI) Tax	=	Total FICA Tax Rate	Maximum FICA Wages	Maximum Tax
1981	5.35		1.30		6.65	29,700	1,975.05
1982	5.40		1.30		6.70	32,400	2,170.80
1983	5.40		1.30		6.70	35,700	2,391.90
1984	5.40		1.30		6.70	37,800	2,532.60
1985	5.70		1.35		7.05	39,600	2,791.80
1986	5.70		1.45		7.15	42,000	3,003.00
1987	5.70		1.45		7.15	43,800	3,131.70
1988	6.06		1.45		7.51	45,000	3,379.50
1989	6.06		1.45		7.51	48,000	3,604.80
1990	6.20		1.45		7.65	51,300	3,924.45
1991	6.20					53,400	3,310.80
			1.45			125,000	1,812.50
1992	6.20					55,500	3,441.00
			1.45			130,200	1,887.90
1993	6.20					57,600	3,571.20
			1.45			135,000	1,957.50
1994	6.20					60,600	3,757.20
			1.45			unlimited	
1995	6.20					61,200	3,749.40
			1.45			unlimited	
1996	6.20					62,700	3,887.40
			1.45			unlimited	
1997	6.20					65,400	4,054.80
			1.45			unlimited	
1998	6.20					68,400	4,240.80
			1.45			unlimited	
1999	6.20					72,600	4,501.20
			1.45			unlimited	
2000	6.20					76,200	4,724.40
			1.45			unlimited	
2001	6.20					80,400	4,984.80
			1.45			unlimited	
2002	6.20					84,900	5,263.80
			1.45			unlimited	

Table 45-1. FICA Percentages and Maximum Taxable Wages and Maximum Tax